

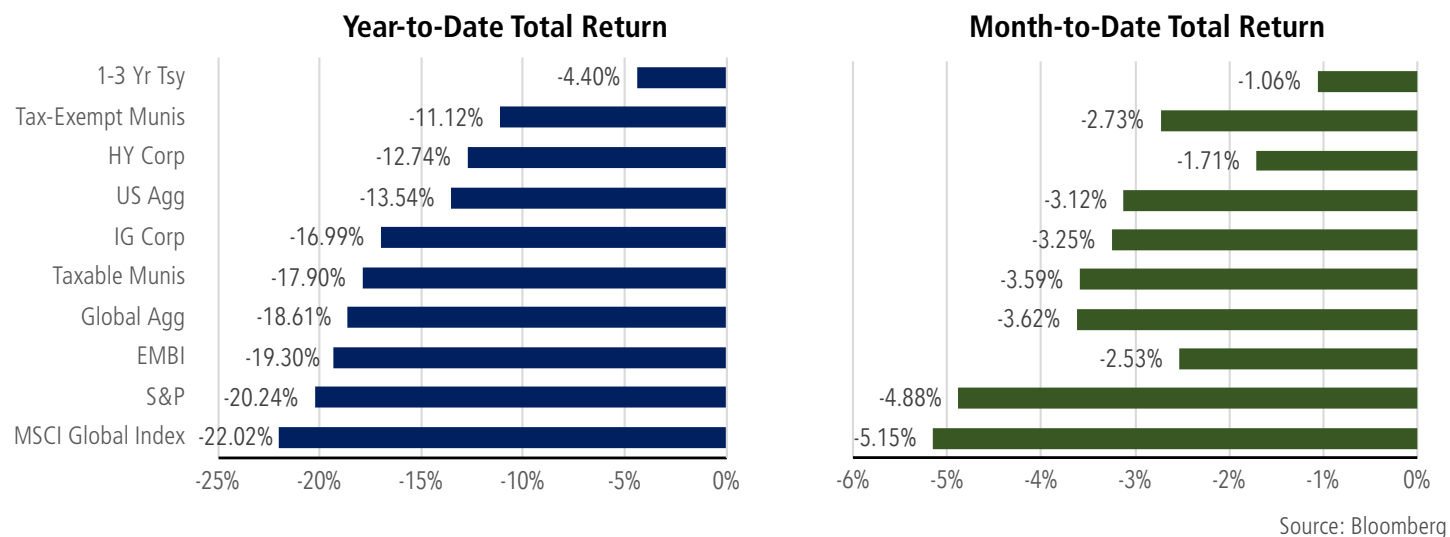
Week Ending: **September 23, 2022**

## Stress Test

### Economic Overview:

Jerome Powell and the Fed joined a host of global central banks hiking rates this week. For his part, Powell pledged to "keep at it until the job is done," paying homage again to Fed Chair Paul Volcker's memoir, "Keeping At It." For Powell, "it" refers to squashing inflation with rate hikes. The Fed has hiked its policy rate by 300 basis points (bps) this year, including a third 75 bps rate hike delivered this week. The median Fed policymaker sees rates at 4.25-4.50% by year-end. We expect the Fed to reach its "terminal" rate of 4.75-5.00% by February 2023. If the Fed delivers, it will mark the sharpest one-year percentage point increase in the policy rate since Volcker's storied 1981 campaign. Many people wonder how exactly rate hikes will stop inflation in the short run. Central bankers won't admit it, but the plan is a recession. Drive up the unemployment rate, drive down inflation (the good 'ole Phillips Curve relationship). While we expect earnest pursuit of the plan, it's not an easy task. And, since financial fragility follows sharp policy tightening, beware of unintended consequences. [If the Fed delivers, it will mark the sharpest one-year percentage point increase in the policy rate since Volcker's storied 1981 campaign.](#)

### Total Returns by Asset Class



### Highlights of the Week:

**High Yield:** The rise in yields this year has been dramatic. On September 22, 2021, the yield-to-worst for the broad high yield universe was 3.81%. That's lower than the yield on the 2 year treasury, which closed at 4.12% yesterday. The yield for high yield now stands at 8.74%.

**Corporates:** Concerns are growing surrounding corporate default risk and future downgrades as borrowing costs continue to move higher with the Fed increasing rates by 3% year-to-date as they look to get a grasp on inflation. Currently across the three main rating agencies, \$865 billion of debt has a negative rating bias. Barclays expects \$180 billion of downgrades in the next six months, 1.6 times higher than upgrades. UBS strategists forecast the default rate could jump as high as 6% by H1 2023.

**Securitized Products:** With all eyes on the Fed this week, CMBS new issue and trading was relatively muted. As investors continue to digest higher interest rates and potential future recession, spreads have leaked marginally wider but remain inside the year-to-date highs seen in mid-summer.

**Municipals:** Front-end municipal rates increased by 30 basis points this week as the Fed continued hiking interest rates. Municipal investors can now find 1-yr AA-rated bonds at tax-free yields of almost 3%. For California investors in the top tax-rate, that's the equivalent of a 6%+ yield in a fully taxable security.

**Equities:** The U.S. equity market continues its late-summer downward trend with the cyclical areas of the market leading stocks lower. The worst performing sectors were energy, consumer discretionary and materials, while consumer staples, utilities and health care were the best performers.